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Hawaii's net income tax

ENLARGING HAWAII'S NET INCOME TAX

Report No. 4 - 1949

Legislative Reference Bureau
University of Hawaii

ENLARGING HAWAII'S NET INCOME TAX

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Summary

The Legislative Reference Bureau was requested to investigate possible means of increasing revenues from Hawaii's personal income tax, which in 1948 yielded approximately $1.5 million, about 3 per cent of total tax revenues going toward support of the territorial government.

Specifically, this Bureau was asked to estimate the tax rates necessary to raise $20 million, with exemptions of $500 for single persons, $1,000 for married couples, and $200 for each additional dependent, allowing business deductions, but no personal deductions--federal taxes or others. On the basis of income received in Hawaii in 1947 and reported in 1948, it is estimated that the rates required to raise $20 million would range from 4% on the first $500 of taxable income to 13% on all above $25,000. (Table 5, page 16.) Allowing all present deductions reduced the tax base to the extent that rates beginning at 5% on the first $500, and rising to 18% on income over $25,000 are required to raise $20 million.

Revenues sufficient to replace the combined yields of the present income tax and the 2% compensation-dividends tax ($11.4 million in 1948) might be obtained from a net income tax law maintaining the present deductions of $1,000 for single persons and $2,000 for married couples, and with rates ranging from 4 to 13%, providing that deductibility of the federal income tax is discontinued. Fifteen other combinations of income tax structures and rates, yielding estimated revenues varying from $9 million to $23 million are also examined. (Chart 1, page 19.)

This Bureau was further requested to report on the possibility of gearing the territorial income tax to that of the federal government. It appears that a law setting the Hawaii levy as a fraction of the federal tax, <u>automatically including amendments which may be made in the federal revenue act</u>, may be held an unconstitutional delegation of the Territory's taxing power. (See page 22.) However, there are precedents for a tax imposed as a share of the federal income tax, <u>computed according to the U. S. revenue act of a given date</u>. To raise $20 million, it is estimated that such a tax would have to be set at approximately one-third of each person's federal tax in 1948. (See page 25.)

Using net income reported to the federal government as the base of the territorial income tax is also considered in this report. (See page 26.) This method permits adoption of a short tax form. Withholding of taxes on wages at the source may be continued under an expanded territorial income tax, as under the federal income tax.

The effect of fully integrating the net income tax of Hawaii with the compensation-dividends tax would be to impose similar tax burdens upon all individuals with identical net incomes and family responsibilities. Under the present compensation-dividends and net income tax laws, wage earners and dividend recipients are taxed upon their net incomes more heavily than are self-employed persons. (See pages 4-7.)

Any greatly expanded income tax would increase the tax burden markedly on middle and higher incomes, and for single persons at virtually all levels of taxable income. (See pages 35-37.) Expressed in average terms, such a tax would materially increase Hawaii's per capita income tax payments.

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ENLARGING HAWAII'S NET INCOME TAX

While Hawaii was one of the first jurisdictions of the United States to adopt and successfully enforce a personal net income tax, it has not employed this levy as a major source of revenue.[1] Especially since the enactment of the general excise (gross income) tax, compensation-dividends tax, and excises on motor fuel, liquor, and tobacco during the period of the depression, Hawaii's graduated tax on personal income has become a fiscal device of distinctly small importance. The yield of this tax, even following the increase in rates voted by the 1947 legislature, amounted to less than $1.5 million in the calendar year 1948, some 2.3 per cent of the Territory's total tax collections, or approximately 3 per cent of the tax revenues going toward support of the territorial government.[2]

In order to discuss comprehensively the taxation of incomes by Hawaii, either with the present tax structure or with possible modifications of it, it is necessary to consider the special taxation of personal compensation and of dividends as well as the net income tax itself. As subsequently shown, under the existing laws the net income and compensation-dividends taxes are partially integrated, with the yields of the former levy being directly influenced by the revenues raised under the tax on compensation and dividends.[3]

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[1]The Hawaii personal income tax was first imposed in 1901. At this time but one American state, Virginia, had a net income tax in force. (An earlier levy of the Hawaiian Republic was declared unconstitutional in 1897.)

[2]That is, exclusive of unemployment compensation taxes, property taxes and the counties' share of the general excise tax.

[3]The general excise (gross income) tax imposed by the Territory on all business enterprises and measured by their gross receipts is not considered in this report on net income taxes. In the absence of detailed, extensive cost studies, it appears impossible to state with any precision the amount of this tax which is shifted or to estimate its impact upon net in-

1. <u>How Personal Income is Now Taxed by Hawaii</u>

Personal income is now taxed by Hawaii under two laws: salaries, wages, and dividends are assessed under the compensation-dividends tax; other receipts are taxed under the net income tax. The former tax, levied at the flat rate of 2 per cent, is actually heavier in most instances than the graduated net income tax, since the 2 per cent levy does not provide for any exemptions or deductions.

Under the present tax laws, personal income, generally speaking, is divided into two classes: (i) wages, salaries, and dividends; and (ii) business profits, interest, rent, professional earnings, and other receipts of the self-employed. Employees and dividend recipients are taxed upon their entire (gross) income, without deductions or exemptions, at the flat rate of 2 per cent under the compensation-dividends tax. As discussed below, they may be taxed an additional amount under the net income levy.

Self-employed persons, receivers of property income, and others falling into the second category are taxed upon their net income, after deduction of business expenses, business and personal taxes, interest payments, contributions, bad debts, uninsured losses, etc. Persons taxed on their net income are further granted exemptions of $1,000 if single, $2,000 for man and wife, and $200 for each additional dependent.

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comes. The effect of not considering the general excise tax (as well as other territorial taxes measured by sales or gross receipts) is to underestimate the <u>total</u> tax burden on all groups of taxpayers. To the extent that the general excise tax is absorbed by the enterpriser, his share in the support of government is understated. To the extent that the tax is shifted to the consumer, his tax burden is similarly understated.

Neither does this report consider the territorial corporate income tax, a flat 10 per cent levy. While imposed on net incomes of corporations, the base of this business tax has no necessary relationship to the ability-to-pay of persons, which is the chief charactertistic of the individual income tax.

Most wage and salary earners pay only under the 2 per cent (gross) compensation-dividends tax, for they are allowed to credit three-fourths of their payment of this tax against their computed net income tax. This offset is enough to cancel out any net income tax obligation for all employees, except those in the higher wage and salary brackets or those who receive income from sources not taxed by the 2 per cent levy. In recognition of this fact, the territorial Tax Commissioner by administrative regulation has excused persons receiving less than $2,800 annually, entirely taxed under the compensation-dividends tax, from filing net income tax returns. (Of 45,094 returns made in 1948 by wage earners, only 10,310 showed taxable income, on which personal income taxes collected totalled $125,285.)

Rates of the personal net income tax are nominally progressive, amounting to 3 per cent on taxable income up to $5,000; 3½ per cent on amounts between $5,000 and $10,000; 4 per cent between $10,000 and $20,000; 4½ per cent between $20,000 and $40,000; 5 per cent between $40,000 and $70,000; 5½ per cent between $70,000 and $100,000; and 6 per cent on the portion of taxable income over $100,000. Actually, as Table 1 shows, only a relative handful of persons pay at the higher rates. Of 78,741 personal net income tax returns made in 1948, 75,491 (or 95.9 per cent) reported either no taxable income or income taxable only at the base rate of 3 per cent. An additional 2,458, or 3.1 per cent showed income taxable in part at 3½ per cent. In all, but 792--1.0 per cent--of the 78,741 returns included amounts taxable at more than 3½ per cent.

For the great bulk of net income taxpayers, it may be seen the tax is only graduated from 3 to 3½ per cent. Going up the income scale, deductibility of steeply progressive federal income taxes increasingly acts to hold

down the effective rate of the territorial tax. At all income levels, the personal exemptions allowed under the net income tax (but not under the compensation-dividends tax), further reduces the effective tax paid.

TABLE 1

DISTRIBUTION BY INCOME BRACKETS OF INDIVIDUAL RETURNS
UNDER THE PRESENT HAWAII INCOME TAX

(1947 income reported in 1948)

Returns with taxable income	Highest tax rate applicable	No. of returns	Net taxable income	Total income[a]	Percentage of total: Returns	Percentage of total: Income[a]
None	---	10,712	---	$ 15,571,361	13.60%	4.68%
Up to $5,000	3%	64,779	$108,920,305	268,633,082	82.26%	80.87%
$5 -10,000	3½%	2,458	16,442,530	26,476,318	3.12%	7.97%
$10-20,000	4%	661	8,678,665	13,799,133	0.82%	4.15%
$20-40,000	4½%	113	2,858,669	5,194,279	0.14%	1.56%
$40-70,000	5%	13	642,234	1,603,726	0.02%	0.48%
$70-100,000	5½%	3	230,724	523,586	(b)	0.15%
Over $100,000	6%	2	235,730	358,073	(b)	0.10%
Total		78,741	$138,008,857	$332,159,558	99.97%[c]	99.97%[c]

Source: Data compiled by the Bureau of Net Income Taxes, Office of the Tax Commissioner.

[a]Adjusted gross income, i.e., after business deductions, but before personal deductions and exemptions.
[b]Less than 0.01 per cent.
[c]Due to rounding, does not add to 100.00 per cent.

Comparison of the amount of tax levied on wages, salaries, and dividends, under both the 2 per cent compensation-dividends and the net income taxes, and that paid under the net income tax by self-employed persons receiving equal incomes is made in Table 2 (page 5). The relative weights of the two taxes are estimated for seven levels of income: $1,000, $2,000, $3,000, $5,000, $8,000, $20,000, and $50,000. At each level, three cases are examined: the tax paid by a single person; by a married man with no

TABLE 2

TAXATION OF COMPENSATION AND DIVIDENDS COMPARED WITH TAXATION OF OTHER FORMS OF INCOME IN HAWAII

Dependency status of taxpayer	Income[a]	Tax, if income received as compensation and dividends	Tax, if income received from other sources[b]	Effective tax rate: On compensations and dividends	Effective tax rate: On other income
Unmarried: no dependents	$1,000	$20.00	0	2.00%	0%
Married: no children	1,000	20.00	0	2.00%	0%
Married: two children	1,000	20.00	0	2.00%	0%
Unmarried: no dependents	$2,000	$40.00	$21.00	2.00%	1.05%
Married: no children	2,000	40.00	0	2.00%	0%
Married: two children	2,000	40.00	0	2.00%	0%
Unmarried: no dependents	$3,000	$60.00	$45.00	2.00%	1.50%
Married: no children	3,000	60.00	18.00	2.00%	0.60%
Married: two children	3,000	60.00	12.00	2.00%	0.40%
Unmarried: no dependents	$5,000	$117.00[c]	$92.00	2.34%	1.84%
Married: no children	5,000	100.00	66.00	2.00%	1.32%
Married: two children	5,000	100.00	60.00	2.00%	1.20%
Unmarried: no dependents	$8,000	$199.00[c]	$159.00	2.49%	1.99%
Married: no children	8,000	176.00[c]	136.00	2.20%	1.70%
Married: two children	8,000	171.00[c]	131.00	2.14%	1.64%
Unmarried: no dependents	$20,000	$538.00[c]	$438.00	2.69%	2.19%
Married: no children	20,000	518.00[c]	418.00	2.59%	2.09%
Married: two children	20,000	516.00[c]	416.00	2.58%	2.08%
Unmarried: no dependents	$50,000	$1,266.00[c]	$1,016.00	2.53%	2.03%
Married: no children	50,000	1,336.00[c,d]	1,086.00[d]	2.67%	2.17%
Married: two children	50,000	1,344.00[c,d]	1,094.00[d]	2.69%	2.19%

(Continued on next page)

TABLE 2 (continued)

TAXATION OF COMPENSATION AND DIVIDENDS COMPARED WITH TAXATION OF OTHER FORMS OF INCOME IN HAWAII

Source: See Appendix III for method by which estimates were made.

[a]Income includes all wages, salary, dividends, net interest, net profits, net royalties, net rents, etc., but before deduction of personal exemptions, contributions, and other subtractions from taxable income allowed under the territorial personal income tax law.

[b]Approximated, allowing for personal exemptions, federal income tax (for 1948), and estimated additional deductions. For brackets $20,000 and $50,000, assumes equal division of income between spouses for tax purposes. Tax rounded to nearest dollar.

[c]Includes payment of territorial net income tax, as well as 2 per cent compensation-dividends tax, since credit of 3/4 of latter tax is not sufficient to offset entire net income tax.

[d]The seeming incongruity of the tax increasing with the number of dependents is due to the (deductible) federal tax on married person being smaller, resulting in a higher territorial income tax.

children; by a married man with two dependent children. In each case the tax liability of a person deriving his taxable income entirely from wages, salary, and dividends is compared with the tax on the same amount of income, derived entirely from sources exempt from the 2 per cent compensation-dividends tax, but taxable under the personal income tax, such as net business income, net professional earnings, net rentals, etc.

Throughout the range of income examined, territorial taxes on compensation and dividends are heavier than those imposed on other forms of income. While the nominal rate of the personal income tax is graduated from 3 to 6 per cent, the <u>effective</u> rate[4] is zero on incomes up to approximately $1,200 for single persons--up to $2,500 or more for married couples with one or more dependents--thereafter increasing gradually. Not until an annual income in the vicinity of $20,000 is reached does the effective rate of the personal income tax equal that of the flat 2 per cent compensation-dividend levy alone. (A self-employed person making an income of $3,000 a year, and claiming the support of his spouse and two children, for example, would pay about $12, compared with the $60 tax assessed on a wage-earner with identical income and family responsibilities.)

At the income level of about $3,000 in the case of unmarried persons, and at approximately $6,000, in the case of married couples, salary and wage earners as well as dividend recipients begin to pay net income taxes to the Territory, in addition to compensation-dividend taxes. Offsetting three-

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[4]Computed by dividing the amount of tax by the amount of income, after deduction of business expenses, but before deduction of personal expenses or personal exemptions. This income (referred to as "adjusted gross income") is comparable to the wages, salaries, and dividends used as the base of the compensation-dividends tax. Both sums comprise the income available, <u>before</u> payment of personal taxes, to a taxpayer and his family for expenditure or saving.

fourths of the latter tax no longer suffices to cancel out the computed income tax. The effect, again, is to impose a larger tax on personal compensation and dividends than on other types of income. As shown in Table 2, for incomes of $8,000 or more, the tax on employees and dividend receivers is uniformly 0.5 per cent higher than on persons deriving their incomes from other sources.[5]

2. Additional Revenue from Changes in the Present Net Income Tax Law

Yields of the present income tax may be increased by reducing exemptions, deductions, or both. However, even if both exemptions and deductions are entirely eliminated, estimated revenues from the net income tax would not exceed about $10 million annually, providing the present offset of 3/4 of compensation-dividends taxes is retained.

A tax which distinguishes among persons according to their ability to pay is necessarily complex. Hawaii's income tax, like that of the federal government and most states, includes personal exemptions, several types of deductions, and graduated rates. The complexity of the income tax in Hawaii is further increased by its partial integration with the compensation-dividends tax, and by the existence of the territorial community property law, which permits man and wife to "split" their income for tax purposes and thus minimize their tax bill.

It is possible to increase revenues from the territorial income tax by altering any or all of these factors: scope of taxable income, exemptions, deductions, rates, and offsetting of the 2 per cent tax. Of the large number of changes which might be made, this report considers (i) revenues forthcoming from lowering of the exemptions and deductions of the present tax law; (ii) revenues which might be anticipated from an income tax law with effec-

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[5]This follows from the fact that only three-fourths of the 2 per cent tax--or 1.5 per cent of the total income--is offsetable against the computed income tax. In effect, this leaves a tax, in addition to the net income tax, of 0.5 per cent of the taxpayer's income.

tive rates higher than those now in force, fully integrated with a withholding tax on wages, salaries, and dividends. Not discussed is possible modification of the community property law, nor are estimates made of the amount of additional tax receipts which might be forthcoming if the scope of the tax law were enlarged to include forms of income presently not taxed, such as taxable military compensation and capital gains.

One means of expanding income tax revenues, while preserving the present rates and all other provisions of the law, would be to reduce or even eliminate non-business deductions. (This would mean that business expenses would continue to be deductible in arriving at the tax base, but that personal deductions, including interest on personal debt, contributions, taxes, etc., would no longer be deductible.) The largest single type of non-business deduction consists of federal personal income taxes, which for 1947 income reported in 1948 comprised more than three-fourths of total non-business deductions. If Hawaii, following the example of California, Maryland, Mississippi, New York, North Carolina, South Carolina, Virginia, and the District of Columbia, were to discontinue the deductibility of federal income taxes, from this alone it would derive approximately $2 million additional income taxes. (This estimate, shown in Table 3, was computed from 1948 returns on 1947 income. Reduction of the federal income tax rates in 1948 will in all probability lower this deduction from the territorial income tax for the ensuing fiscal period.)

TABLE 3

ESTIMATED POTENTIAL REVENUE FROM THE PERSONAL NET INCOME TAX*

(Under present rates, based on 1947 income reported in 1948)

Present tax structure (actual collections, 1948)	$ 1,478,000
With only federal income taxes not deductible	3,400,000
With no non-business deductions (federal income tax or other)	4,100,000
With no personal exemptions (but with all present deductions)	7,800,000
With neither personal exemptions nor non-business deductions	10,400,000

Source: Estimated on basis of data compiled by the Bureau of Net Income Taxes, Office of the Tax Commissioner. See Appendix III for methods used in making estimates.

*In each case, estimates are predicated on assumption that present offset of 3/4 of compensation-dividends tax is retained.

If all non-business deductions were abolished, but present exemptions retained, the Territory would collect additional revenues of approximately $2.6 million from the present tax, as indicated in the table above. This would bring the annual yield of the personal net income tax to somewhat above $4 million, almost triple its present level, but still far short of constituting a primary revenue source for the Territory of Hawaii.

Yields of the individual net income tax may also be increased within the general framework of the present tax law by reducing personal exemptions. Personal exemptions now provided--$1,000 for a single person; $2,000 for a married couple; $200 for each additional dependent; $1,000 for trusts and other fiduciaries--are indeed higher than those of several state income taxes

and might be lowered as a means of obtaining additional revenue.[6] As the level of exemptions is reduced, the tax base is broadened to include an ever greater number of low incomes, and a progressively larger portion of incomes hitherto untaxed. If the extreme step of eliminating all personal exemptions were taken, additional revenues estimated at approximately $6.3 million might be obtained.[7]

Finally, if both personal exemptions and all non-business deductions were eliminated, the largest amount of revenues possible under the present net income tax base and tax rates would be realized. As estimated in Table 3, on the basis of 1947 income, this drastically modified tax law would yield somewhat above $10 million. It would also be a levy unique among the net income taxes of the states and territories of the United States, insofar as it would make no allowance for different family responsibilities or for exceptional outlays (as for large charitable contributions or bad debts) of taxpayers.[8]

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[6]See Legislative Reference Bureau, Personal Exemptions Under the Hawaii Income Tax, (Report No. 3, 1947), Appendix 1, pp. 10-12.

[7]An earlier report of this Bureau indicated that most of the additional revenue would be derived from lower income groups, with the heaviest added burden being placed upon heads of families, who would then pay larger income taxes than single persons with identical incomes. (The latter have their territorial taxes reduced by virtue of higher federal income taxes, which are deductible under the Hawaii levy.) Legislative Reference Bureau, Personal Exemptions Under the Hawaii Income Tax (Report No. 3, 1947), Appendix 2, p.13. (The data shown in this appendix are no longer current since they are based in part upon 1947 federal tax rates. However, the effects of repealing exemptions there illustrated remain substantially unchanged.)

[8]Every state which imposes a comprehensive personal net income tax allows personal exemptions. (Tennessee alone of the income tax states does not permit exemptions, but it taxes only income from securities and other intangibles.) Without exception, all state personal income taxes allow some non-business deductions.

(It should be pointed out that the above revenue estimates, as well as all made subsequently in this report, assume (i) that both the total and the distribution of personal income taxable by Hawaii remain substantially identical to that received in 1947 and reported in 1948; and (ii) that the present level of compliance with the tax laws is continued. However, as effective rates are raised, it may be expected that tax avoidance and evasion will increase, in the absence of measures to curb such reduction of the tax base.)

3. <u>Basic Changes in Net Income Tax Required to Produce Substantial Revenue</u>

Inclusion of salaries and wages as well as higher effective tax rates is necessary to increase income tax yields toward the $20 million mark. Reducing exemptions to half of their present level for single and married persons may produce approximately $20 million annually, at rates beginning at 4 or 5 per cent and graduated up to 13 to 18 per cent--depending on the deductions allowed.

Investigation reveals, therefore, that changes more basic than reduction in personal exemptions or deductions are necessary to increase the revenue potential of Hawaii's net income tax toward the level of $20 million suggested for this study. Substantially, it is necessary to include in the net income tax base salaries and wages under $3,000, now virtually entirely excluded from taxation under the net income levy, although taxed under the 2 per cent compensation-dividends tax. As shown in Appendix I, such earnings amounted to more than $254 million in 1947, almost half of all personal income reported for tax purposes under both the net income and compensation-dividend taxes.

If the compensation-dividends tax were repealed and the present offset of three-fourths of this levy thus eliminated, the Territory would collect additional net income revenues, estimated at approximately $4 million. This would raise the total income tax yield up to $5.5 million (since the current

collections approximate $1.5 million), but at the cost of the $9.9 million received under the compensation-dividends tax during 1948.

Alternatively, the 2 per cent tax might be retained, but the present provision of the law which permits crediting three-fourths of compensation-dividend tax payments against a person's computed net income tax abolished. This would result in multiple taxation by the Territory of the income of wage-earners and dividend recipients, groups previously shown to be taxed more heavily than other income receivers. As this may not appear a feasible means of obtaining additional income tax revenues, this problem suggests the consideration of completely integrating the compensation-dividends and net income taxes, so that all persons with identical incomes and family responsibilities pay the same tax. Under such a tax structure, taxes would still be withheld on wages, salaries, and dividends, but as a means of collecting at the source the territorial income tax, as under the federal income tax law. It is this approach which is employed in the following sections of this study.

a. Smaller personal exemptions:

In order to increase in large measure Hawaii's income tax receipts, currently approximating $11.4 million annually ($9.9 million from the compensation-dividends tax, $1.5 million from the personal net income tax) it is necessary to raise the effective rates paid. This may be accomplished in several ways: (i) by retaining present exemptions and personal deductions and drastically increasing the nominal rates (i.e., the rates imposed by law on each taxable income bracket); (ii) by eliminating or drastically reducing the exemptions and deductions and raising the nominal rates by a lesser amount; (iii) by combinations of these approaches.

It has been shown that reduction or even elimination of personal exemptions would not make a major revenue source of the present net income tax, as long as the compensation-dividends levy with its provision for offsetting against the net income taxes is continued. However, under a comprehensive personal net income tax, applying in full and equally to wages and salaries, as well as other types of income, the level of exemptions is extremely important in determining the amounts which would be collected.

TABLE 4

EFFECT OF PERSONAL EXEMPTIONS UPON INCOME TAX YIELD

(Estimated on basis of 1947 income reported in 1948)

	Tax A	Tax B	Tax C
Exemptions:			
Single person	$1,000	$ 500	$250
Married couple	2,000	1,000	500
Each dependent	200	200	100
Deductions:	None	None	None
Tax Rates:	3% on first $5,000 ...up to 6% on all over $100,000	3% on first $5,000 ...up to 6% on all over $100,000	3% on first $5,000 ...up to 6% on all over $100,000
Estimated Yield:*	$6,860,000	$10,350,000	$12,780,000

*See Appendix III for methods used in making estimates.

Examination reveals that with the current exemptions of $1,000 for single persons (and fiduciaries), $2,000 for married couples or family heads, $200 for dependents, a comprehensive tax with no deductions or offsets, at the present rates, would have yielded less than $7.0 million, on the basis of income received during 1947. (Tax A in Table 4.) If these exemptions were lowered to $250, $500, and $100, respectively--under the same tax rates

and still without deductions (Tax C)--the estimated yield would amount to $12.8 million, as shown in the above table. Exemptions intermediate between these two levels (Tax B) would produce somewhat above $10.3 million, on the basis of income received in 1947 and reported in 1948.

For the remainder of this (third) part of the study, the following intermediate system of personal exemptions is tentatively assumed: $500 for single persons, $1,000 for couples and heads of families, $200 for additional dependents.[9] These exemptions, adopted for purposes of exploring the revenue potentialities of Hawaii's income tax, would exclude from the tax base about one-third of the personal income received by taxpayers of this Territory. (Under the exemptions in the present territorial net income tax, approximately three-fifths of personal income in Hawaii, which totalled about $522 million in 1947, would be eliminated from the tax base.)[10]

b. <u>Increased tax rates</u>:

Reduction of personal exemptions comprises one possible step in the expansion of Hawaii's personal income levy. Additional revenues can then be produced by applying higher rates to the broadened tax base, the level of rates in turn being determined by the deductions permitted and amount of revenue sought.

To illustrate the effective tax rates--that is, considering exemptions and deductions, as well as the nominal rates--which would be required to expand the net income tax into a primary revenue source, the following Table 5 (page 16) shows the elements of a graduated income tax which would yield

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[9]Among the state income taxes, those of Kansas and Utah most closely approximate these exemptions, being currently set at $500, $1,500, $300, and $600, $1,200, and $300, respectively. Until increased by a popular referendum held in November, 1948, Oregon's exemptions were $500, $900, and $300.

[10]See Appendix II.

TABLE 5

ALTERNATIVE INCOME TAX STRUCTURES DESIGNED TO YIELD $20 MILLION

(Estimated on basis of 1947 income reported in 1948)

	Tax I	Tax II	Tax III	Tax IV
Exemptions:	Single person, $500 Married couple, $1,000 Each dependent, $200	Single person, $500 Married couple, $1,000 Each dependent, $200	Single person, $500 Married couple, $1,000 Each dependent, $200	Single person, $500 Married couple, $1,000 Each dependent, $200
Deductions:	None	10% of adjusted gross income, up to $500 per taxpayer ($250 per spouse)	All present deductions except federal income tax	All present deductions
Tax Rates:	4% on 1st $500 5% on 2nd $500 6% on 2nd $1,000 7% on 3rd $1,000 8% on 4th $1,000 9% on 5th $1,000 10% on $5,000-$7,000 11% on $7,000-$10,000 12% on $10,000-$25,000 13% on all over $25,000	5% on 1st $500 6% on 2nd $500 7% on 2nd $1,000 8% on 3rd $1,000 9% on 4th $1,000 10% on 5th $1,000 11% on $5,000-$10,000 12% on $10,000-$15,000 13% on $15,000-$25,000 14% on all over $25,000	5% on 1st $1,000 6% on 2nd $1,000 7% on 3rd $1,000 8% on 4th $1,000 9% on 5th $1,000 10% on 6th $1,000 11% on 7th $1,000 12% on $7,000-$10,000 13% on $10,000-$15,000 14% on $15,000-$25,000 15% on all over $25,000	5% on 1st $500 6% on 2nd $500 8% on 2nd $1,000 10% on 3rd $1,000 12% on 4th $1,000 14% on 5th $1,000 16% on $5,000-$10,000 17% on $10,000-$25,000 18% on all over $25,000
Estimated Yield:	$20,060,000	$20,020,000	$20,000,000	$20,060,000

Source: Estimated from data compiled by the Bureau of Net Income Taxes, Office of the Tax Commissioner. See Appendix III for methods used in making estimates.

approximately $20 million, the goal suggested by the members of the legislature requesting that this study be made.

Table 5 indicates that approximately $20 million of income tax revenue may be raised by various combinations of allowable deductions and of tax rates ---the more liberal the deductions, the higher the rates. Thus, under a tax law with personal exemptions of $500 for a single man or woman, $1,000 per couple, and $200 per dependent, but eliminating all non-business deductions allowed under the present law (Tax I in the table), rates ranging from 4 per cent on the first $500 of taxable income to 13 per cent on the fraction of taxable income above $25,000 are estimated to yield approximately $20 million.

This amount of revenue may also be raised annually by limiting non-business deductions to 10 per cent of adjusted gross income (i.e., after allowing for all business expenses), up to a maximum of $500 per taxpayer or $250 each for man and wife making separate returns (Tax II). With such deductions, similar to the optional standard deduction of the federal income tax and of several state taxes, rates ranging from 5 per cent to 14 per cent are indicated.

Alternatively, some $20 million of revenue--always assuming the same total and distribution of personal income as that received in 1947 and reported in 1948--may also be approximated by eliminating the deductibility of federal income taxes,[11] and by imposing tax rates scaled from 5 per cent on

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[11]Among the states imposing personal net income taxes, California, Maryland, Mississippi, New York, North Carolina, South Carolina, and Virginia, as well as the District of Columbia, do not permit deduction of federal income taxes. Such deductions are limited to 50 per cent of federal tax payments in Arkansas, to 3 per cent of net income in Wisconsin, and to a maximum of $500 in Vermont.

the first $1,000 to 15 per cent on all taxable income over $25,000. (This is shown as Tax III in Table 5.)

If all present deductions were continued as in Tax IV, the amount of taxable income would be smaller than in any of the three cases examined above. With the exemptions assumed in Table 5, tax rates graduated from 5 per cent on the first $500 of taxable income to a maximum of 18 per cent on amounts over $25,000 would be required to obtain $20 million from this base. This rate structure, it will be noted, is graduated along most of its range by two percentage point intervals, while the preceding rate structures progress by one-point steps.

4. How Revenues Smaller than $20 Million May be Raised

A given amount of income tax revenue may be approximated by any one of several combinations of rates, exemptions, and deductions. Chart 1 illustrates several possible combinations which would raise from $9 million to $23 million, estimated according to income received in 1947.

The preceding discussion considered raising approximately $20 million of annual income tax revenues, the amount suggested by the requestors of this report as a possible goal for income tax revision. However, if consideration is given to increasing collections from this source above the present level, but short of the $20 million mark, it is of interest to estimate the yields from alternative tax structures as the effective rates are varied.

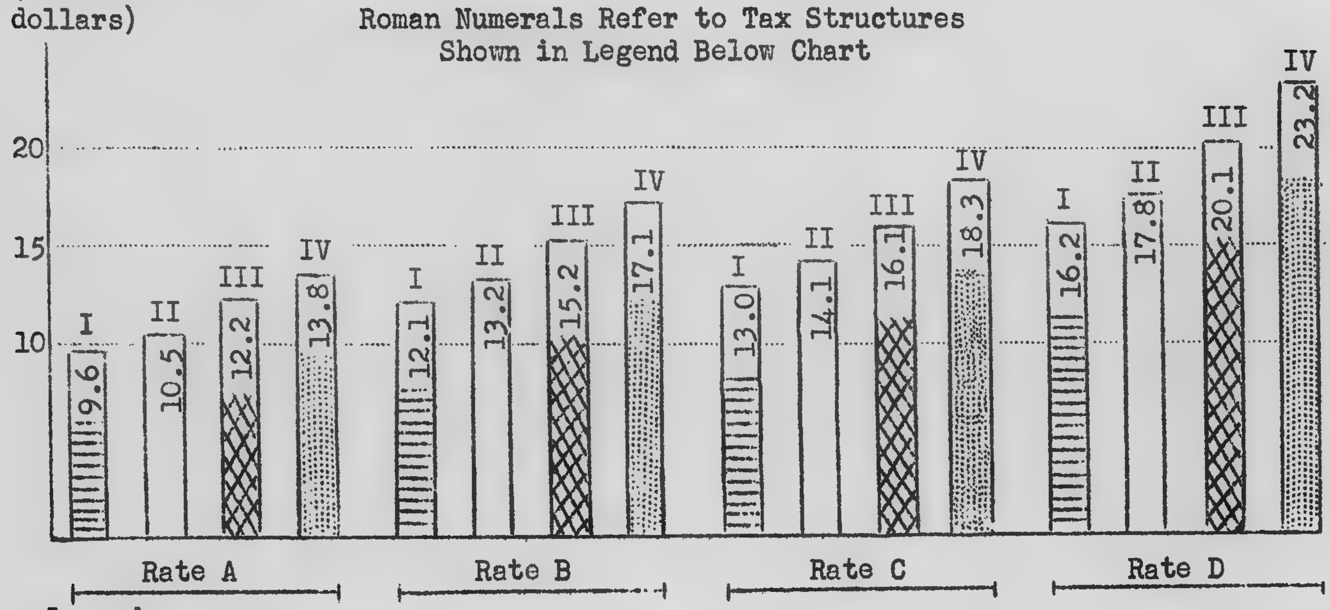
This comparison is made in Chart 1 (page 19) which shows the estimated revenues which may be anticipated from four tax laws, as the rates are set at various levels. As in this entire portion of the report, three basic assumptions have been made: (i) that the amount and distribution of personal income approximates that received in 1947 (reported in 1948); (ii) that the compensation-dividends tax is fully integrated with the net income tax; (iii) that tax avoidance and evasion does not increase markedly.

CHART 1

ESTIMATED YIELDS FROM ALTERNATIVE INCOME TAX STRUCTURES*

(Estimated on basis of 1947 income reported in 1948)

Estimated Annual Yield (millions of dollars)



<u>Legend</u>:

1. <u>Tax rates</u>:
   - A. 3% on 1st $500, 4% on 2nd $500, 5% on 2nd $1,000, 6% on 3rd $1,000, 7% on $3-5,000, 8% on $5-10,000, 9% on all over $10,000.
   - B. 4% on 1st $500, 5% on 2nd $500, 6% on 2nd $1,000, 7% on 3rd $1,000, 8% on 4th $1,000, 9% on 5th $1,000, 10% on $5-7,000, 11% on $7-10,000, 12% on $10-25,000, 13% on all over $25,000.
   - C. 5% on 1st $1,000, 6% on 2nd $1,000, 7% on 3rd $1,000, 8% on 4th $1,000, 9% on 5th $1,000, 10% on 6th $1,000, 11% on 7th $1,000, 12% on $7-10,000, 13% on $10-15,000, 14% on $15-25,000, 15% on all over $25,000.
   - D. 5% on 1st $500, 6% on 2nd $500, 8% on 2nd $1,000, 10% on 3rd $1,000, 12% on 4th $1,000, 14% on 5th $1,000, 16% on $5-10,000, 17% on $10-25,000, 18% on all over $25,000.

2. <u>Tax structure</u>:
   - I. <u>Exemptions</u>: Single person $1,000, married couple $2,000, $200 per dependent; <u>deductions</u> as under present law, <u>except</u> for federal income taxes.
   - II. <u>Exemptions</u>: Single person $1,000, married couple $2,000, $200 per dependent; <u>no</u> non-business deductions.
   - III. <u>Exemptions</u>: Single person $500, married couple $1,000, $200 per dependent; <u>deductions</u> as under present law. (Same as Tax IV in Table 5, p. 16.)
   - IV. <u>Exemptions</u>: Single persons $500, married couples $1,000, $200 per dependent; <u>deductions</u>: 10% of adjusted gross income, up to $500 per taxpayer ($250 per spouse). (Same as Tax II in Table 5, p. 16.)

*See Appendix III for methods used in making estimates.

Reference to Chart 1 indicates that a given amount of individual income taxes may be raised by several combinations of exemptions, deductions, and rates--of which the chart shows sixteen examples. Thus, if approximately $12 million of revenue were required, the following tax might be imposed: tax rates ranging from 4 per cent on the first $500 of taxable income to 13 per cent on amounts over $25,000 (rate B in the chart); with the present exemptions of $1,000 for single persons, $2,000 for family heads, $200 for dependents; and with all present deductions except federal income taxes (structure I).

Approximately $13 million would be forthcoming at these same rates (rate B) from the tax structure designated II, which provides the same exemptions, but eliminates all non-business deductions. If the present deductions are retained, some $12 million may be obtained under a system of rates beginning at 3 per cent on the first $500 of taxable income, graduated up to 9 per cent on taxable income exceeding $10,000, if personal exemptions were reduced to $500 for single persons and $1,000 for married couples. (Tax structure III, rate A.)

It is estimated that approximately $16 million could be raised from this same tax structure III and the system of tax rates designated C (5 per cent on the first $1,000 to 15 per cent on all over $25,000). Tax structure IV (same exemptions as III; deductions limited to 10 per cent of adjusted gross income, up to a maximum of $500 per taxpayer, or $250 for each spouse) and the group of rates designated B in the above chart would also yield between $16 and $18 million annually.

From Chart 1, it may also be seen that income tax revenue approximating $20 million can be anticipated from either tax structure III or IV,

if the highest rates here considered, ranging from 5 per cent to 18 per cent on taxable income over $25,000, are applied (rate D).

5. An Income Tax Based on the Federal Personal Income Levy

A Hawaii income tax assessed as a fraction of current federal income taxes is likely to be held unconstitutional. However, a tax may be imposed by reference to the federal revenue act of a given date. On the basis of U. S. income taxes collected in Hawaii in 1947-48, the Territory would have to levy a tax of about one-third the federal income tax to raise $20 million.

A territorial tax using as its base the amount of taxable income reported to the federal government and permitting exemptions of $500, might yield about $10 million at rates beginning at 3 per cent and graduated up to 9 per cent, or approximately $13 million at rates ranging from 5 per cent to 15 per cent. Revenues under the same rates, but with deductibility of federal taxes limited to a maximum of $500 (as in Vermont), are estimated at $11 million and $15 million, respectively.

The Legislative Reference Bureau was also requested to report on the feasibility of basing the Hawaii income tax on that levied by the federal government. With such an arrangement, each resident would be required to remit to Hawaii a set fraction of his income tax under the federal law.

A territorial income tax imposed by reference to the United States income tax might conceivably take any of four forms: (i) it might require payment of a certain percentage of the individual's current federal income tax, thus making Hawaii's tax take cognizance of all changes in the federal revenue act; (ii) it might require payment of a tax computed on a base determined by reference to the provisions of the present and any future federal revenue act; (iii) it might require payment of a certain percentage of a federal income tax computed by reference to the provisions of the present federal revenue act, without regard to subsequent amendments by Congress; (iv) it might require payment of a tax computed on net income as reported under the present federal revenue act, but with independent exemptions and rates specified by Hawaii's legislature.

The constitutionality of the first two types of tax-by-reference is extremely dubious. The initial method, making both the tax base and tax rates dependent upon future action of Congress, would appear to be an improper delegation of power to the federal government. The second, although not relying upon Congressional enactment for the fixing of rates, would still depend upon federal statutes defining the tax base, and thus is subject to the same objection. That these methods are unconstitutional seems clear with respect to legislation by any of the states: it is likely that a territorial statute imposing a tax which correspondingly varies with the federal income tax would also be held unconstitutional in the absence of legislation by Congress approving such delegation.[12]

a. <u>A territorial tax imposed as a fraction of the federal income tax</u>:

Precedents exist for the third form of tax, since the constitutionality of at least two state income taxes of this type has been upheld by the courts. South Carolina in 1922 levied a tax set at 33 1/3 per cent of the federal income tax, computed in terms of the federal revenue act of 1921. The courts held that this procedure did <u>not</u> constitute an improper delegation of legislative power to Congress.[13] The same decision was reached with

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[12] In the <u>Santee Mills</u> and <u>Featherstone</u> cases, noted immediately below, the court was explicit in affirming the power of a state legislature to adopt federal acts of a given date as the bases of state laws, but in denying its power to so adopt a federal act <u>as it might be amended in the future</u>. In <u>Featherstone</u> v. <u>Norman</u> (153 S.E. 58 at 70) the court carefully pointed out: "This act in no way undertakes to make future federal legislation a part of the law of this state upon that subject. When a statute adopts a part or all of another statute, domestic or foreign . . . by specific and descriptive reference thereto, the adoption takes the statute as it exists at that time. The subsequent amendment or repeal of the adopted statute or any part thereof has no effect upon the adopting statute." See also dictum in <u>Commonwealth</u> v. <u>Warner Bros. Theatres, Inc.</u>, 345 Pa. 270, 27 Atl. 2d. 62.

[13] <u>Santee Mills</u> v. <u>Query</u>, 122 S.C. 158, 115 S.E. 202 (1922).

respect to a similar law passed by the Georgia legislature in 1929.[14] This statute also set the state income tax at one-third of the individual's federal tax liability, computed under provisions of the then-extant revenue act.[15] As further discussed subsequently, Vermont has adopted the federal definition of net income as the basis for applying the rates established in the state income tax act. Here, too, it is the definition as incorporated in the federal revenue act of a particular year, 1947, not the act as it may be amended by Congress.

Both the South Carolina and Georgia taxes referred to were subsequently repealed and replaced by income taxes with bases independent of the federal income tax. A letter from the director of the income tax division of the South Carolina Tax Commission reveals the legal and administrative difficulties inherent in a state or territorial income tax defined by reference to a federal revenue act of a preceding year.[16]

> The Act of 1922 presented many difficulties which increased with age. The principal obstacle to effective and smooth administration arose from the fact that the General Assembly could adopt Federal law, rules and regulations which were in effect at the time of the adoption, but could not adopt future Federal law or regulations or even future rules and regulations promulgated under authority of the Federal law actually adopted for South Carolina. Such condition developed an ever-widening hiatus between effective Federal law and the Federal law upon which the South Carolina tax was based. Even though basic Federal law will remain unchanged, the regulation and administrative interpretations which followed

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[14] Featherstone v. Norman, 170 Ga. 370, 153 S.E. 58 (1930).

[15] The Georgia statute, ambiguous in its reference to the federal law, was interpreted by the state supreme court to adopt the existing federal revenue act, as shown above in footnote 12.

[16] Letter from O. W. Livingston, dated January 12, 1949.

after the passage of the South Carolina Act made proper administration by South Carolina extremely difficult.

Another great difficulty stands clear in the writer's memory and that was the trouble experienced in determining the taxable net income of individuals and corporations and fiduciaries doing business or having an income in more than one State.

The mathematics of estimating the yield of this form of tax would be relatively simple in the period immediately following its adoption. In most cases no allowance need be made for exemptions or deductions, since these would already be embodied in the federal tax, on which the territorial levy would be based.

The chief complications which would arise in approximating expected revenues from a tax defined as a fraction of the United States income tax center about the division of taxing powers under a federal form of government. Thus, the federal tax base may include personal income of residents derived from economic activities outside Hawaii--which the Territory may not wish to tax--or income, such as interest on federal securities or military compensation of non-residents within the Territory--which the Territory cannot tax. However, while the legal and administrative complexities inherent in this form of taxation might prove vexatious to its enforcement, they would not materially affect an estimate of its yield in the first years of its enforcement, for the vast bulk of the tax base consists of personal compensation and business income unambiguously derived from economic activities within the Territory.

In the fiscal year 1947-48 the federal government collected $75,179,000 of individual income taxes in Hawaii. Assuming that the entire amount was paid on income taxable by Hawaii,[17] if the Territory had required its inhab-

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[17] Current data is not available on the portion of the base for federal income taxes which is not taxable by the Territory.

itants to pay approximately 26.6 per cent of their federal income tax bill to the Office of the Tax Commissioner, it would have raised some $20 million.

If the fiscal year 1948-49 were adopted as a base, two offsetting factors would have to be allowed for in estimating revenue yields. One is the presumed increase in personal income between 1947 and 1948;[18] the other is the reduction in federal income tax rates, which became effective at the beginning of 1948. Of the two, the latter is probably of greater magnitude, for the federal levy was lowered by increasing personal exemptions from $500 to $600 and by decreasing rates by 17 per cent on amounts of tax up to $400, plus 12 per cent on the amount of tax over $400 but not in excess of $100,000, plus 9.75 per cent of the portion of computed tax over $100,000. In order to produce $20 million, the Territory would therefore have to levy a somewhat larger percentage of the federal income tax for 1948-49. The required fraction may be estimated at approximately one-third.[19]

Adoption of the federal tax law as the basis of a Hawaii income tax would enlarge the present definition of taxable income. Thus, capital gains

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[18]For the entire United States, total personal income apparently rose some 4 per cent between December, 1947 and November, 1948. (U.S. Department of Commerce, Survey of Current Business, Vol. 29, No. 1, January, 1949, p. S-1.) In Hawaii, the base of the compensation-dividends tax, which encompasses the major part of personal income, increased but 1 per cent in 1948 over 1947, according to data of the Office of the Tax Commissioner.

[19]This estimate was arrived at in the following manner. The aggregate amount of federal tax in Hawaii for 1947-48--$75,179,000--was expanded by 1 per cent to reflect the increase in personal income between 1947 and 1948 suggested by the compensation-dividends tax base. (See preceding footnote.) This amount was then reduced by 18.75 per cent, the fraction by which the nation's personal income tax bill would be cut by the 1948 tax reductions (exclusive of the effect of income splitting between spouses--already effective in Hawaii under the community property law) as estimated by the Senate Finance Committee. (U.S. Code, Congressional Service, Revenue Act of 1948, With Official Legislative History, West Publishing Co., 1948, Table XIV, p. 602). The resulting sum, $61,693,000, was then divided by $20,000,000 to arrive at the estimated rate.

realized on the disposition of real estate and securities, presently not taxed by Hawaii, would become subject to taxation, wherever subject to the Territory's jurisdiction, as would compensation received by members of the armed forces.[20] In addition, an optional standard deduction (as an alternative to itemized deductions) would in effect be incorporated into the territorial income tax, if the tax were imposed by reference to the federal revenue act.[21]

b. <u>A territorial tax imposed on the federal income tax base</u>:

Vermont recently enacted an income tax of the fourth type here considered, one which adopts the taxpayer's net income (exclusive of capital gains and losses) as reported to the federal government under the present federal revenue act. After deduction of federal income taxes, up to $500, as well as income not taxable by Vermont, and exemptions of $500 for the taxpayer and each dependent, the amount of tax is computed according to the rates adopted by the state legislature.[22]

From the viewpoint of convenience and certainty of yield, this form of taxation which uses the amount of <u>reported income</u> on the federal income tax return seems preferable to one which uses the amount of federal <u>income tax paid</u> as a base for computing the territorial income tax. The amount of

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[20]At the present time, Hawaii cannot tax members of the armed forces on their compensation merely because of their being here for military service. (50 U.S.C.A. Appendix sec. 574.)

[21]Substituting the federal income tax law for the present Hawaii income tax would also result in further changes. For example, alimony would then be deductible to the payer, but taxable to the receiver. Medical expenses amounting to more than 5 per cent of adjusted gross income would be deductible. Most important, personal exemptions would be reduced to $600 for each taxpayer, spouse, and dependent.

[22]Public Act 15, 1947. (Chapter 43, Vermont Statutes 1947.) See the following section of this report (p. 30) for a brief discussion of the administration of Vermont's income tax.

tax paid to the United States on a given income has varied frequently in recent years, and this would directly and unpredictably influence the amount of territorial revenues forthcoming from a levy imposed as a fraction of each individual's federal tax payment. However, most of this fluctuation has occurred because of changes in federal exemptions and rates, while the definitions of gross income and deductions, which determine the amount of income reported (the tax <u>base</u>), have been amended but slowly over recent years.

Data is lacking by which to estimate with any accuracy the probable yields of a tax modelled after the Vermont levy--that is, based on income reported to the national government--for as noted on pages 25-26, the definition of taxable income is somewhat wider under the federal law than under the present Hawaii income tax. However, the following table includes estimates of the revenues which might be forthcoming from a tax of this nature, on the basis of taxable income actually reported to the Territory in 1948 (received in 1947).

TABLE 6

ESTIMATED REVENUE FROM TERRITORIAL TAX BASED ON INCOME REPORTED UNDER THE FEDERAL PERSONAL INCOME TAX

(Estimated on basis of 1947 income reported in 1948)

	TAX A	TAX B	TAX C	TAX D
Exemptions:	$500 for taxpayer, spouse, and each dependent			
Federal Taxes Deductible:	In full	Up to $500	In full	Up to $500
Tax Rates:	3% on first $500...up to 9% on all over $10,000[a]		5% on first $1,000...up to 15% on all over $25,000[b]	
Estimated Yield:	$10,700,000	$11,600,000	$14,200,000	$15,500,000

Source: Data compiled by Bureau of Net Income Taxes, Office of the Tax Commissioner. See Appendix II for method by which estimates were made.
[a]Same as Rate A in Chart 1 (p. 19).
[b]Same as Rate C in Chart 1 (p. 19).

Table 6 indicates that a Hawaii income tax, using as its base taxable income reported to the federal government, and permitting deduction of all federal income tax payments and separate exemptions of $500 for the taxpayer, for his spouse, and for each additional dependent, would raise more than $10 million from rates beginning at 3 per cent on the first $500 of taxable income and graduated up to 9 per cent on income in excess of $10,000. (Tax A, in Table 6.) The same tax, with rates ranging from 5 per cent on the first $1,000 of taxable income to 15 per cent on all over $25,000, would produce about $14 million, estimated on the basis of 1947 income. (Tax C.)

If the Vermont system of limiting deductibility of federal personal income taxes to a maximum of $500 for each return were adopted, the tax base would be expanded, moderately, with respect to (adjusted gross) income brackets of $4,000 to approximately $6,000, with increasing rapidity for income brackets above this level. As a result the yields would be larger, approximating $11.6 million under the lower set of rates considered above (Tax B), or $15.5 million under the higher rates (Tax D).

6. <u>A Pay-as-you-go Income Tax; Administrative Provisions</u>

Deduction of taxes at the source, as under the present compensation-dividend tax, may be retained under a net income tax. Withholding tables, such as those used for the federal tax, could enable employers to deduct taxes from wages and salaries. Adoption of the federal income tax base would permit the use of a simplified tax return. Under any expanded income levy the administrative load of the Office of the Tax Commissioner would be increased.

If Hawaii's net income tax were expanded significantly, either by modifying the present tax or by substituting a levy based upon the federal personal income tax, both the taxpayer and the territorial government would benefit by providing for a pay-as-you-go method of collection. The government would benefit by receiving a more even flow of revenues over the year; the taxpayer by paying his tax in regular installments out of current income,

rather than in lump sums during the following year, when his economic position may be altered.[23]

The principle of pay-as-you-go collection is implemented under the present 2 per cent compensation-dividends tax by deduction of the tax at the source by the employer and corporate dividend payer. This system of source collection of employees' and dividend recipients' taxes could be continued without substantial modification under a comprehensive net income levy. Since the tax would be graduated and include personal exemptions varying with marital status and number of dependents, it may be desired to amend the present procedure of withholding a flat percentage of all wages, salaries, and dividends. Instead, the amount collected at the source from each employee could be determined according to withholding tables, similar to those of the federal income tax (but probably simpler, since the number of tax brackets would presumably be smaller than for the steeply graduated federal tax). Additional taxes due, or overpayments subject to refund, would be computed at the end of the tax year, as under the United States income tax.

If the Hawaii tax were imposed as a <u>fraction of the federal tax</u>, the administrative problems of source collections would be minimized until the federal revenue act is amended in a material manner. The present W-2 Form of the federal government, showing taxable income and withheld taxes (and in Hawaii now also showing compensation-dividend taxes deducted at the source) would suffice as a return for most employees, while other taxpayers would be

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[23]The Oregon income tax law provides for the deduction of 1 per cent of salary and wages, such withholding to be applied against the computed tax. Several other states require withholding of income taxes on amounts paid to non-residents (<u>e.g.</u>, California, Colorado, Iowa, Kentucky, Louisiana, New York, and Vermont).

required only to report their tax as computed for federal purposes, less amounts allocated to income derived outside Hawaii. However, as the experience of South Carolina cited above illustrates, such a tax would become increasingly difficult to administer, both with respect to source collections and collections made on the basis of returns, as the federal revenue act adopted by reference became more and more obsolete. If federal income tax exemptions and rates continue to change as frequently in the future as they have in the recent past, it is not a pleasing prospect, for example, to contemplate the task of administering in 1955 a Hawaii income tax based upon the federal income levy of 1948.

However, adoption of a territorial tax using as its base the amount of income currently reported to the federal government could greatly simplify the administrative problem of checking the tax due, as well as reducing the number of computations required of the taxpayer. As discussed in the preceding section of this report, Vermont recently adopted an income tax of this nature. The income tax return of that state, reproduced in Appendix IV, contains but seven entries for computing the individual's tax liability. Gross income is first copied from the federal tax form (line 6 of form 1040 or 1040A). Net income[24] as reported to the federal government, exclusive of capital gains and losses, is then entered. Deduction is then made of federal personal income taxes, up to a maximum of $500, as well as of income which is not taxable by the state, such as interest on certain federal securities. Finally, exemptions of $500 for the taxpayer, his spouse, and each dependent are subtracted to arrive at net taxable income.

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[24]After all deductions, but before personal exemptions.

The graduated tax rates are then applied against this amount to arrive at the tax due. This short form is further abbreviated for persons reporting less than $5,000 of taxable income. At their option such taxpayers may simply read their tax from a table printed on the back of the duplicate tax form (retained by them). This table, similar to that incorporated in the federal income tax, is divided into income brackets of $50, with provision for exemptions ranging from one to six.

Vermont's tax has now been in operation for more than a year. According to that state's tax department, using income reported under the federal tax as the base of the state tax has worked well from the administrative viewpoint. The Vermont Commissioner of Taxes writes:

> I feel that I can recommend our Act most highly from an administrative point of view because it is much easier to process and store the simple return which is filed and if we need additional information, it is always possible to receive it.[25]

With respect to the problem of tax collection in Hawaii, it should be pointed out that enactment of an income tax which would apply to any substantial number of persons presently excused from filing returns would increase the administrative load of the Office of the Tax Commissioner. In particular, additional returns would have to be processed for part of the group--the number depending upon the level of exemptions--who now are taxed under the compensation-dividends tax, and due to the device of crediting three-fourths of this tax against their computed income tax, have no net income tax liability. (For example, if all persons filing federal income returns were required to report their taxable income to the Territory, some

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[25]Letter from George H. Amidon, dated January 26, 1949.

206,000 returns would have been made in 1948. Under the present Hawaii income tax 78,741 returns actually were filed during 1948.)

7. Use of Tax Credits to Provide for Personal Exemptions

Tax credits may be substituted for personal exemptions. They somewhat simplify computation of the individual's tax. An additional effect is to increase slightly the tax paid at all levels of income above the lowest bracket.

The various tax structures heretofore considered provide for personal exemptions, to be deducted in the computation of taxable income. Similar provision is made in the present Hawaii net income levy and those of most states which impose an individual income tax.

An alternative method of allowing exemptions to reflect the varying family responsibilities of taxpayers is to permit them to subtract a designated amount from their computed tax, rather than from their taxable income. This system has been adopted by five states. In Arizona, each taxpayer may credit against his tax $10 for himself, $10 for his spouse, and $4 for each additional dependent. Iowa has the same credits for man and wife, but allows a tax deduction of $5 per dependent. Credits in Minnesota are set at $10 for the taxpayer, $30 for a married couple, and $10 for each dependent. Wisconsin permits tax credits of $8, $17.50, and $4, for the single person, married couple, and for every dependent, respectively. Finally, Kentucky (where the beginning tax rate is 2 per cent, against 1 per cent in each of the preceding four states), provides credits of $20 for a single taxpayer, $50 for man and wife, and $10 for each dependent.

Substituting tax credits for exemptions may somewhat simplify the making of income tax returns, since the exemption is thus stated for the taxpayer in terms of the amount he may subtract from his computed tax. In addition, incorporation of this device in the income tax structure makes

personal exemptions of equal value at all levels of income. This follows from the fact that the value to the taxpayer of conventional exemptions, as under the federal or present Hawaii levies, increases with his income: exemptions in effect reduce the amount taxable in the highest bracket in which a taxpayer's income falls. (Thus an exemption of $1,000 lowers the tax by $100, if a person is in an income bracket taxable at a rate of 10 per cent, but it only lowers the tax of a person in a 5 per cent bracket by $50.) However, under the tax-credit system, the computed tax is reduced by an identical amount for all persons with the same number of dependents, regardless of the amount of their incomes.

8. Per Capita Income Tax Burdens; How Increased Income Taxes Would Affect Persons at Various Income Levels

Net income taxes per head of civilian population averaged $2.75 in Hawaii during 1948. Including compensation-dividends taxes brought overall per capita income tax payments to $21--slightly above the highest average among mainland states. Expanding the net income tax would proportionately increase Hawaii's per capita burden. Individual tax payments, at various income levels, are estimated under four possible income tax structures in Table 6 and compared with present taxes.

Expansion of the net income tax to a major source of territorial revenue would necessarily increase the average tax burden in the Territory. Under the present laws, Hawaii in 1948 collected personal net income tax averaging $2.75 for each of its 540,500 civilian population. Compensation-dividend tax revenues, per head of population, amounted to approximately $18.24, bringing the aggregate net income-compensation and dividends tax burden to about $21.00.

If the income tax, reconstituted so as to be fully integrated with the withholding tax on wages, salaries, and dividends were expanded to raise $12 million annually, the average income tax paid by each civilian in Hawaii

would amount to about $22.20. An income tax yielding $15 million, in turn, would impose a burden averaging $27.75 per capita, while the per capita average under an $18 million or $20 million income tax would approximate $33.30 and $37.00, respectively. By way of comparison, the highest per capita income tax collected by any mainland state in 1948 was $19.72--received by Oregon. For all of the thirty-one states imposing personal net income taxes in 1948, income tax collections per head of population averaged approximately $6.20.

Per capita tax payments are, of course, averages, and do not indicate the amount of tax liability at different income levels. It remains to examine the relative tax burdens which would be borne by persons in various tax brackets, if an enlarged personal income tax were legislated. As in the preceding discussion, it is here assumed that differential taxation of compensation and dividends would be discontinued, with the present 2 per cent withholding tax fully integrated into the net income tax structure.

In Table 7 (page 35), the taxes now paid by persons under the present income taxes are compared with their estimated tax liability under four possible expanded net income taxes. This comparison is made at seven levels of adjusted gross income (after deduction of business expenses, but before deduction of personal exemptions and deductions): $1,000, $2,000, $3,000, $5,000, $8,000, $20,000, and $50,000. In each case, the approximate amount of tax is shown for single persons, married couples with no children, and married couples with two dependent children.

Payments under the present taxes on personal income, which yielded some $11.4 million in the calendar year 1948 ($9.9 million from the compensation and dividends, $1.5 million from the net income tax), it should be

TABLE 7

ESTIMATED TERRITORIAL TAXES UNDER EXPANDED INCOME TAX COMPARED WITH PRESENT TAXES*

Dependency status of taxpayer	Income[a]	Present income taxes		Expanded income tax (all groups)			
		Employee[b]	Self-employed[c]	Tax I[d]	Tax II[e]	Tax III[f]	Tax IV[g]
Unmarried: no dependents	$1,000	$20	0	0	0	$21	$20
Married: no children	1,000	20	0	0	0	0	0
Married: two children	1,000	20	0	0	0	0	0
Unmarried: no dependents	$2,000	$40	$21	$47	$50	$63	$68
Married: no children	2,000	40	0	0	0	38	40
Married: two children	2,000	40	0	0	0	27	20
Unmarried: no dependents	$3,000	$60	$45	$101	$110	$110	$124
Married: no children	3,000	60	18	43	50	86	92
Married: two children	3,000	60	12	23	30	74	68
Unmarried: no dependents	$5,000	$117	$92	$238	$260	$213	$260
Married: no children	5,000	100	66	144	160	166	204
Married: two children	5,000	100	60	120	136	154	188
Unmarried: no dependents	$8,000	$199	$159	$507	$560	$398	$560
Married: no children	8,000	176	136	326	360	312	400
Married: two children	8,000	171	131	298	332	300	368
Unmarried: no dependents	$20,000	$538	$438	$1,974	$2,130	$1,219	$2,130
Married: no children	20,000	518	418	1,466	1,600	1,080	1,660
Married: two children	20,000	516	416	1,418	1,552	1,076	1,612
Unmarried: no dependents	$50,000	$1,266	$1,016	$6,075	$6,570	$2,690	$6,570
Married: no children	50,000	1,336	1,086	5,346	5,660	2,946	5,730
Married: two children	50,000	1,344	1,094	5,286	5,604	2,974	5,674
ANNUAL YIELD[h]		$11,400,000		$13,000,000	$14,100,000	$16,100,000	$18,300,000

(Continued on next page)

TABLE 7 (continued)

ESTIMATED TERRITORIAL TAXES UNDER EXPANDED INCOME TAX COMPARED WITH PRESENT TAXES*

Source: Based on data furnished by the Bureau of Net Income Taxes, Office of the Tax Commissioner.

*Note: Where net income taxes are thus minimized, estimates are of taxes paid by married couples on separate returns, with income evenly divided between spouses. See Appendix II for methods used in making estimates.

[a]Net income, after deduction of business expenses, but before deduction of personal exemptions or deductions.

[b]Under 2 per cent compensation-dividends tax and personal net income tax, when applicable.

[c]Under personal net income tax.

[d]Personal exemptions: $1,000 if single, $2,000 for couple, $200 per dependent. Deductions: same as under present law, except for federal income tax. Rates: 5% on 1st $1,000, 6% on 2nd $1,000, 7% on 3rd $1,000, 8% on 4th $1,000, 9% on 5th $1,000, 10% on 6th $1,000, 11% on 7th $1,000, 12% on $7,000-$10,000, 13% on $10,000-$15,000, 14% on $15,000-$25,000, 15% on all over $25,000. (Same as Tax I, Rate C in Chart 1, p. 19.)

[e]Personal exemptions: $1,000 if single, $2,000 for couple, $200 per dependent. No deductions. Rates: same as for Tax I. (Same as Tax II, Rate C in Chart 1, p. 19.)

[f]Personal exemptions: $500 if single, $1,000 for couple, $200 per dependent. Deductions: same as under present law. Rates: same as for Tax I. (Same as Tax III, Rate C in Chart 1, p. 19.)

[g]Personal exemptions: $500 if single, $1,000 for couple, $200 per dependent. Deductions: 10% of adjusted gross income, up to $500. Rates: same as Tax I. (Same as Tax IV, Rate C in Chart 1, p. 19.)

[h]Estimated on basis of income received in 1947.

noted, are here compared with payments under tax laws which are estimated to raise some $13 million (Tax I in the table below), $14 million (Tax II), $16 million (Tax III), and $18 million (Tax IV).

9. The Joint Impact of Territorial and Federal Income Taxes

Combined federal and territorial income taxes are estimated under two possible Hawaii income tax laws, one permitting deduction of all federal taxes, the other limiting personal deductions to $500.

While Hawaii, as any of the states, is not required to limit its tax structure by virtue of existing federal taxes, the legislature may properly be concerned with the total tax burden imposed by both levels of government upon the incomes of its residents. To illustrate the joint impact of federal and territorial income taxes, Table 8 (pages 39-40) estimates the amounts which would be due under the United States and the Hawaii levies upon persons receiving the following amounts of adjusted gross income (after deduction of business expenses, but before personal exemptions or deductions): $1,000, $2,000, $3,000, $5,000, $10,000, $20,000, $50,000, $100,000, and $750,000. The tax at each level of income, computed both for single persons (Table 8A) and married couples with two dependents (Table 8B), is based upon the assumptions that all income is fully taxable, including neither capital gains nor tax-free interest. The estimated tax liabilities for upper income groups, therefore, approach the <u>maximum</u> amounts possible under the tax structures considered--almost fictitious amounts, it might be added, since there is every reason to believe that persons in top brackets will avail themselves of the minimizing possibilities inherent in both federal and territorial income taxes.

The two hypothetical Hawaii income taxes which have been used to estimate the burden at each income level both provide for exemptions of $500 for

single persons, $1,000 for each couple, and $200 for dependent. The first allows all deductions currently included under the present net income tax, with rates graduated from 4 per cent on the first $500 of taxable income to a maximum of 13 per cent on amounts above $25,000. This tax structure, it was earlier estimated, (see Chart 1, page 19) would yield around $15 million annually, approximately $3.8 million dollars more than the total yield in 1948 from the territorial personal income tax and the compensation-dividends tax combined.

The second territorial income tax employed for illustrative purposes in Table 8 provides for a standard deduction amounting to 10 per cent of adjusted gross income (before subtracting personal exemptions), up to a maximum of $500 per taxpayer. The assumed rates vary from 5 per cent on taxable income up to $1,000 to 15 per cent on taxable income exceeding $25,000. Its annual yield was estimated at about $18 million, assuming personal income in Hawaii approximating that received in 1947 (and reported in 1948).

Either tax, of course, is much smaller than the federal levy, which begins with a rate of 16.6 per cent on the lowest income bracket and then progresses by means of twenty-five graduations to a maximum rate of 82.1275 per cent. (Actually, the total federal tax can not exceed 77 per cent, and is so shown at this marginal rate in Table 8 with respect to the highest income there considered--$750,000.)

Because it does not provide for full deduction of the federal income levy, the second territorial tax here considered takes a far larger portion of incomes over $5,000 than does the first hypothetical tax, which does allow complete deduction of the highly graduated federal tax. Thus, in the

TABLE 8A

INCOME TAX LIABILITIES UNDER PRESENT FEDERAL AND HYPOTHETICAL HAWAII INCOME TAXES

(Estimated for single persons with no dependents)

	Hawaii Tax[b]		United States Tax Under:		Total Taxes: U.S. and T.H.		Marginal Tax Rate[c]		
Income[a]	Tax I	Tax II	T.H. Tax I	T.H. Tax II	Under Tax I	Under Tax II	T.H.-I	T.H.-II	U.S.
$1,000	$ 16	$ 20	$ 52	$ 52	$ 68	$ 72	4%	5%	16.6%
2,000	57	68	201	201	258	269	6%	6%	16.6%
3,000	105	124	356	356	461	480	6%	7%	19.4%
$ 5,000	$ 219	$ 260	$ 695	$ 695	$ 914	$ 955	8%	8%	19.4%
10,000	577	800	1,712	1,653	2,289	2,453	11%	12%	29.9%
20,000	1,313	2,130	4,770	4,419	6,083	6,549	12%	14%	44.0%
$ 50,000	$ 3,098	$ 6,570	$ 18,750	$ 16,640	$ 21,848	$ 23,210	13%	15%	60.7%
100,000	5,390	14,070	48,618	42,270	54,008	56,340	13%	15%	73.9%
750,000	25,550	110,570	520,660	449,700	546,210	560,270	13%	15%	77.0%

Sources: See Appendix II for methods used in making estimates.

[a] Adjusted gross incomes, i.e., after deduction of business expenses, but before allowance for personal exemptions or deductions. Excludes capital gains, interest on federal bonds, and other income not taxable by Hawaii, as well as income not taxable by the United States.

[b] Tax I provides for a personal exemption for single persons of $500; deductions as under the present law; rates of 4% on taxable income up to $500, 5% on $500-$1,000, 6% on $1,000-$2,000, 7% on $2,000-$3,000, 8% on $3,000-$4,000, 9% on $4,000-$5,000, 10% on $5,000-$7,000, 11% on $7,000-$10,000, 12% on $10,000-$25,000, 13% on all above $25,000. This is Tax III, rate B in Chart 1, p. 19; it would yield approximately $15,200,000, estimated on the basis of income received in 1947.

Tax II provides for a personal exemption for single persons of $500; deductions of 10% of income up to maximum of $500; rates of 5% on taxable income up to $1,000, 6% on $1,000-$2,000, 7% on $2,000-$3,000, 8% on $3,000-$4,000, 9% on $4,000-$5,000, 10% on $5,000-$6,000, 11% on $6,000-$7,000, 12% on $7,000-$10,000, 13% on $10,000-$15,000, 14% on $15,000-$25,000, 15% on all above $25,000. This is Tax IV in Chart 1, p. 19, and in Table 6, p. 27; it would yield approximately $18,300,000, estimated on the basis of income received in 1947.

[c] The rate on the highest bracket into which the taxpayer's income falls. Federal rates are as provided by the Revenue Act of 1948. It should be noted that the effective marginal rate is smaller than the sum of territorial and federal tax rates, due to the inter-deductibility of these two taxes. (See p. 42.)

TABLE 8B

INCOME TAX LIABILITIES UNDER PRESENT FEDERAL AND HYPOTHETICAL HAWAII INCOME TAXES

(Estimated for <u>married</u> persons with <u>two</u> dependents)

Income[a]	Hawaii Tax[b]		United States Tax Under:		Total Taxes: U.S. and T.H.		Marginal Tax Rate[c]		
	Tax I	Tax II	T.H. Tax I	T.H. Tax II	Under Tax I	Under Tax II	T.H.-I	T.H.-II	U.S.
$1,000	0	0	0	0	0	0	—	—	—
2,000	$20	$20	0	0	$ 20	$ 20	4%	5%	—
3,000	69	68	$54	$54	123	122	6%	6%	16.6%
$ 5,000	$ 183	$ 188	$ 345	$ 345	$ 528	$ 533	7%	8%	16.6%
10,000	428	529	1,122	1,104	1,550	1,633	8%	9%	19.4%
20,000	1,144	1,612	3,108	2,984	4,252	4,596	11%	14%	26.4%
$ 50,000	$ 3,338	$ 5,674	$ 12,868	$ 11,770	$ 16,206	$ 17,444	12%	15%	49.3%
100,000	6,244	13,155	36,740	32,544	42,984	45,649	13%	15%	60.7%
750,000	26,300	110,655	492,300	423,840	518,600	534,495	13%	15%	77.0%

Source: See Appendix II for methods used in making estimates.

[a] Adjusted gross income, i.e., after deduction of business expenses, but before allowance for personal exemptions or deductions. Excludes capital gains, interest on federal bonds, and other incomes not taxable by Hawaii, as well as income not taxable by the United States.

[b] Tax I provides for a personal exemptions for married couples with 2 dependents of $1,400; deductions as under the present law; rates of 4% on taxable income up to $500, 5% on $500-$1,000, 6% on $1,000-$2,000, 7% on $2,000-$3,000, 8% on $3,000-$4,000, 9% on $4,000-$5,000, 10% on $5,000-$7,000, 11% on $7,000-$10,000, 12% on $10,000-$25,000, 13% on all above $25,000. This is Tax III, rate B in Chart 1, p. 19; it would yield approximately $15,200,000, estimated on the basis of income received in 1947.

Tax II provides for a personal exemption for married couples with 2 dependents of $1,400; deductions of 10% of income up to maximum of $500; rates of 5% on taxable income up to $1,000, 6% on $1,000-$2,000, 7% on $2,000-$3,000, 8% on $3,000-$4,000, 9% on $4,000-$5,000, 10% on $5,000-$6,000, 11% on $6,000-$7,000, 12% on $7,000-$10,000, 13% on $10,000-$15,000, 14% on $15,000-$25,000, 15% on all above $25,000. This is Tax IV in Chart 1, p. 19, and in Table 6, p. 27; it would yield approximately $18,300,000, estimated on the basis of income received in 1947.

[c] The rate on the highest bracket into which the taxpayer's income falls. Federal rates are as provided by the Revenue Act of 1948. It should be noted that the effective marginal rate is smaller than the sum of territorial and federal rates, due to the inter-deductibility of these two taxes. (See p. 42.)

case of single persons, an income of $10,000 would pay $800 under Tax II, $577 under Tax I. At the $50,000 level, Tax II is more than double Tax I. At $750,000--an income higher than any reported in Hawaii during 1948--the first tax amounts to approximately $25,550, while the second, because federal taxes are not fully deductible, exceeds $110,000.

The combined force of both federal and territorial taxes would require payment of about 7 per cent of the income of a <u>single man</u> receiving $1,000 annually, 13 per cent of $2,000, up to 16 per cent of $3,000, 18 to 19 per cent of $5,000. Depending on whether Hawaii Tax I or Tax II in Table 8A (page 39) were imposed, the burden on a $10,000 income received by a single person without dependents would approximate 23 or 24 per cent. The federal tax plus either of these two levies would take from 30 to 33 per cent of an income of $20,000, about 44 to 46 per cent to $50,000, 54 to 56 per cent of $100,000, and 73 to 75 per cent of a single person's income of $750,000. (It may again be pointed out that the estimates of taxes paid out of large incomes implicitly assume that the taxpayer has not fully availed himself of the tax-minimizing provisions of the income tax laws.)

Because of the exemptions provided by both federal and territorial income taxes, the burden on persons with dependents is lighter than in the case of single taxpayers. Part B of Table 8 examines the taxes paid under the federal and hypothetical Hawaii taxes by <u>married couples with two dependents</u>. No tax is assessed at the $1,000 level, while the Hawaii levy alone reaches families receiving $2,000 annually, the amount approximating $20--1 per cent of the family income. The combined weight of the federal and territorial taxes is estimated at about 4 per cent on family income of $3,000, at slightly more than 10 per cent on incomes of $5,000, at 15 to 16 per cent if the income amounts to $10,000 annually.

A family with two dependent children would pay combined income taxes totalling about 21 per cent of an income of $20,000 if territorial Tax I were adopted, while with Tax II the combined federal and territorial tax burden would approximate 23 per cent of this income. At the level of $50,000 aggregate taxes would amount to about 32 or 35 per cent, depending upon which of the two Hawaii taxes were imposed; while on an income of $100,000 estimated taxes of 43 or 46 per cent would be due. At the highest personal income considered, $750,000, a family with two dependents would be taxed at the rate of 69 per cent under the federal tax and hypothetical Tax I, at 71 per cent under the federal tax and hypothetical Tax II.

10. Interdependence of Federal and Territorial Income Taxes

Mutual deductibility of federal and territorial income taxes reduces the impact of graduated rates upon large incomes. At income levels above $5,000, heavier Hawaii taxes represent, in part, transfers of taxes from the federal government to the Territory.

Adoption of a territorial income tax which provides for deduction of federal income taxes, such as that currently in force or the one designated Tax I in the above table (Table 8, pages 39-40), creates a condition of inter-dependence with the federal personal income tax. In determining the amount of federal tax liability, the territorial tax may be deducted; conversely the federal tax would be subtracted from taxable income in computing the amount of tax due to the Territory.

The effect of this two-way deductibility is to lessen the impact of both graduated taxes on large incomes. Thus, at the income level of $10,000, an additional territorial tax of $100 on a single man will reduce his federal tax by about $30. (The marginal tax rate imposed by the federal levy on this income is 29.9 per cent, as shown above in Table 8A, page 39.) An additional tax of $100 assessed on a single person with an income of $50,000 would cause

his federal tax to be reduced by approximately $60, in effect making his net additional tax burden $40, rather than $100. In sum, then, for middle and upper income brackets, heavier Hawaii income taxes will in part be met by imposing new burdens on these taxpayers; in part by transferring some of their present tax payments from the federal to the territorial government.

This effect, which has been taken into consideration in computing Table 8, becomes more pronounced the higher one goes up the income scale.[26] It is of less consequence with respect to incomes under $5,000, for the majority of taxpayers in these brackets elect to use the simplified federal income tax schedule, which contains a set percentage of adjusted gross income to allow for all personal deductions, including state and territorial income taxes. Undoubtedly, however, the adoption of an expanded Hawaii income tax would make it worth while for many additional persons to specify their personal deductions, including their Hawaii income tax.

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[26]If either tax permits deductibility of the other, the sum of federal and territorial income taxes cannot be confiscatory, i.e., equal 100 per cent or more of the income assessed, as long as neither rate is independently confiscatory. ("The sum of a maximum Federal rate of 90 per cent and a maximum state rate of 15 per cent seems to be confiscatory. Actually, it is not. Although the combined tax liability must exceed either of its components computed in the absence of tax deductibility, it is well below the sum of the nominal rates and hence below the point of confiscation. Combined tax liability is 91.5 per cent under unilateral deductibility and 90.1 per cent under reciprocal deductibility." H. E. Klarman, "Income Tax Deductibility," National Tax Journal, Vol. I, No. 3, September 1948, p. 244.)

APPENDIX I

INCOME RECEIVED IN 1947 AS REPORTED TO THE OFFICE OF THE TAX COMMISSIONER

Group Bracket		Taxpayers[a]	Dependents[b]	Tax Base: Compensation[c]	Tax Base: All Other[d]	Total Tax Base	Cumulative Percentage of Total Tax Base
Up to $	500	147,048	4,211	$ 23,090,126	$ 7,371,021	$ 30,461,147	5.84%
$ 500 "	1,000	42,986	17,820	27,760,793	3,125,086	30,885,879	11.76%
1,000 "	1,500	28,192	14,722	32,226,654	3,163,121	35,389,775	18.54%
1,500 "	2,000	28,728	15,003	47,027,626	3,857,856	50,885,482	28.29%
2,000 "	2,500	30,553	13,221	63,761,435	3,794,694	67,556,129	41.23%
2,500 "	3,000	22,394	9,705	60,228,100	3,643,547	63,871,647	53.47%
3,000 "	3,500	17,496	8,147	53,020,479	3,557,281	56,577,760	64.31%
3,500 "	4,000	13,408	7,103	45,913,429	3,778,237	49,691,666	73.84%
4,000 "	4,500	6,644	5,609	24,164,310	3,921,516	28,085,826	79.22%
4,500 "	5,000	4,346	4,430	16,229,327	4,207,844	20,437,171	83.13%
5,000 "	6,000	3,753	3,810	16,284,097	4,023,847	20,307,944	87.03%
6,000 "	7,000	2,097	1,920	8,726,150	4,799,856	13,526,006	89.62%
7,000 "	8,000	1,395	1,375	5,861,581	4,545,506	10,407,087	91.61%
8,000 "	9,000	850	740	4,060,849	3,120,040	7,180,889	92.99%
9,000 "	10,000	565	540	2,867,151	2,522,025	5,389,176	94.02%
10,000 "	15,000	1,073	891	6,741,940	6,017,963	12,759,903	96.47%
15,000 "	20,000	358	300	2,375,291	3,702,565	6,077,856	97.63%
20,000 "	25,000	155	90	1,422,397	1,979,586	3,401,983	98.28%
25,000 "	30,000	69	27	1,056,378	846,829	1,903,207	98.65%
30,000 "	35,000	38	7	430,700	843,180	1,273,880	98.89%
35,000 "	40,000	31	9	525,180	610,440	1,135,620	99.11%
40,000 "	45,000	16	5	209,815	470,488	680,303	99.24%
45,000 "	50,000	18	8	183,680	704,170	887,850	99.41%
50,000 "	60,000	16	7	451,846	443,066	894,912	99.58%
60,000 "	70,000	5	0	195,512	131,842	327,354	99.65%
70,000 "	80,000	2	0	0	143,025	143,025	99.67%
80,000 "	90,000	1	0	0	80,350	80,350	99.69%
90,000 "	100,000	1	0	0	90,664	90,664	99.70%
Over	100,000	7	5	0	1,546,709	1,546,709	100.00%
Grand Total		352,245	109,705	$444,814,846	$77,042,354	$521,857,200	100.00%

(Continued on next page)

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APPENDIX I (continued)

INCOME RECEIVED IN 1947 AS REPORTED TO THE OFFICE OF THE TAX COMMISSIONER

Source: Bureau of Net Income Taxes, Office of the Tax Commissioner.

[a]Community property law given consideration in arriving at the number of taxpayers.

[b]Based partially on estimates.

[c]Based on data taken from information reports furnished by employers.

[d]Net profit from business, interest, partnership income, etc., taken from net income returns, before non-business expenses and personal exemptions.

APPENDIX II

EFFECT OF LEVEL OF EXEMPTIONS ON THE PERSONAL INCOME TAX BASE

System of Exemptions	Estimated Exemptions[a]	Remaining Tax Base[b]	Percentage of Tax Base Removed by Exemptions
1. No exemptions	0	$521,857,000	0%
2. $250 for taxpayer, $250 for spouse, $100 per dependent.	$108,039,000	$413,818,000	20.7%
3. $500 for taxpayer, $500 for spouse, $200 per dependent.[c]	$185,618,000	$336,239,000	35.6%
4. $500 for taxpayer, $500 for spouse, $500 per dependent.[d]	$218,266,000	$303,591,000	41.8%
5. $600 for taxpayer, $600 for spouse, $600 per dependent.[e]	$254,614,000	$267,243,000	46.9%
6. $1,000 for taxpayer, $1,000 for spouse, $200 per dependent.[f]	$300,012,000	$221,845,000	57.5%

[a]Estimated from data on 1947 income compiled by the Bureau of Net Income Taxes, Office of the Tax Commissioner.

[b]Before allowing personal deductions for federal taxes, contributions, bad debts, etc.

[c]Exemptions used in Table 5, p. 16.

[d]Exemptions used in Table 6, p. 27.

[e]Exemptions under present federal income tax.

[f]Exemptions under present territorial income tax.

APPENDIX III

METHODS USED IN ESTIMATING TAX YIELDS AND BURDENS

The basic materials relied upon in this study for purposes of revenue estimation are data on net income and compensation-dividend taxes compiled by the Bureau of Net Income Taxes, Office of the Tax Commissioner, under the direction of Mr. Earl W. Fase, deputy tax commissioner. These statistics, released in October and November, 1948, show by income brackets the number of returns, adjusted gross income, detailed deductions, exemptions, net income, compensation-dividends tax offsets, and amount of tax. Based upon 1947 income reported (in the case of the net income tax) in 1948, this data is the only comprehensive compilation of income tax statistics to be made by the Territory for recent years. Without this information, the present report, or any other attempt to discuss in detail the quantitative aspects of Hawaii's income tax, would be impossible.

The statistical information furnished by the Tax Office was relied upon almost exclusively in the earlier sections of this study, dealing with the present income tax. Attempts to estimate the yields of various hypothetical income taxes discussed in the report, as well as the estimates of tax burdens at various income levels, also made use of the statistical data furnished by the Net Income Tax Bureau--averaged, reformulated, expanded, or combined with additional data or estimates, as required by the problem at hand. The particular data or estimates used in each of the tables and in the charts of the report are briefly indicated below.

Table 1: DISTRIBUTION BY INCOME BRACKETS OF INDIVIDUAL RETURNS UNDER THE PRESENT HAWAII INCOME TAX (p. 4).
This table presents the information reported by the territorial Tax Office. Only the percentages of returns and of total income, as shown in the final two columns, were computed by the Legislative Reference Bureau.

Table 2: TAXATION OF COMPENSATION AND DIVIDENDS COMPARED WITH TAXATION OF OTHER FORMS OF INCOME (p. 5).
The net income tax was estimated for each income level by the following methods. (i) The federal income tax was first computed: from the optional federal income tax table for incomes up to $5,000, by allowing appropriate exemptions and 10 per cent of adjusted gross income for personal deductions in the case of larger incomes. (ii) The computed federal income tax, plus additional deductions approximated at 5 per cent of adjusted gross income, as well as the indicated exemptions, were then subtracted to arrive at the taxable net income. (iii) Current rates were then applied against this figure. (iv) In the case of compensation-dividend taxpayers, the prescribed credit of 3/4 of their compensation-dividend tax was subtracted from their computed net income tax. The balance of income tax due, if any, was added to their 2 per cent tax payment in arriving at the total entered in the third column, "Tax, if income received as compensation and dividends."

Table 3: ESTIMATED POTENTIAL REVENUE FROM THE PERSONAL NET INCOME TAX (p. 10).
Additional revenues which may be forthcoming from an income tax with smaller deductions and/or no exemptions were estimated for two groups separately:

(i) those who already file under the present income tax; (ii) those who were excused from filing during 1948. Estimates for the first group were made on the basis of the statistics prepared by the Tax Office, making the manipulations indicated by each step of this table. (The chief difficulty encountered here was that reducing exemptions and deductions may place persons in a higher income bracket and therefore make inaccurate revenue estimates obtained by applying the top rate at which they actually paid in 1948 against the added taxable income. However, since the brackets of the Hawaii tax are unusually large and the rates comparatively low, the error--on the side of underestimation--from this source is not considered great.)

Estimating the taxes expected from wage-earners and dividend recipients who do not file income tax returns required additional computations. First, the amount which might be paid by these persons under an exemptionless, deductionless tax was approximated by applying the base income tax rate of 3 per cent against their estimated earnings and dividends and then crediting an offset of 3/4 of their compensation-dividend tax payments. To estimate the yield from this group if the income tax retained present exemptions but eliminated deductions, the ratio of dependents to taxpayers under both the income and compensation-dividends taxes (as reported by the Tax Office) was applied against the number of (new) taxpayers in each bracket, to estimate the number of dependents in the groups here considered. Exemptions were then approximated for each level of income by multiplying the estimated number of dependents by $600--an average of the $1,000 exemption for a spouse and the $200 exemption for other dependents (i.e., assuming that half of the dependents claimed are spouses.) Subtracting the aggregate of these estimated exemptions from the previously obtained tax base gave the approximate base for this group of taxpayers, for an income without deductions but with exemptions. The amount of taxes lost because of the existence of exemptions was subtracted from the yield of an exemptionless, deductionless income levy in order to approximate additional revenues from an income tax without deductions. Finally, the same ratio of federal income tax deductions to total non-business deductions reported by the Tax Office for persons filing net income tax returns (some 78 per cent), was applied against estimated deductions to arrive at the tax base, for this group, of an income levy disallowing deductibility of federal income taxes.

Table 4: EFFECT OF PERSONAL EXEMPTIONS UPON INCOME TAX YIELD (p. 14). Taxable income, before exemptions (this table assumes no deductions), was taken from the statement of the Tax Office showing total (adjusted gross) income, as reported both under the compensation-dividends and personal net income taxes. Exemptions for spouses were computed in part by use of the column in the Tax Office report showing the number of joint returns filed in each bracket of taxable income. (These were transposed in terms of adjusted gross income brackets, the base for revenue estimation, by means of the adjustment shown for Table 5.) To allow for an unknown total of spouses, in the case of compensation-dividends recipients not required to file income tax return in 1948, the following adjustment was made. The difference between the number of federal joint returns filed in 1942--latest year for which data is available--by persons receiving less than $2,800 and the number actually filed with the Territory in 1948, was taken as an approximate measure of the number of spouses which would be claimed, in the aggregate, by persons now excused from filing, if they were required to make returns.

Table 5: ALTERNATIVE INCOME TAX STRUCTURES DESIGNED TO YIELD $20,000,000 (p. 16).

The tax base for these estimates, before exemptions or deductions, was taken from the report of the Tax Office showing (adjusted gross) income returned under the compensation-dividends and net income taxes. Exemptions were allowed for on the basis of the number of taxpayers and dependents shown by the Tax Office report, supplemented, as shown for Table 4, by estimates of exemptions for spouses of wage-earners not currently filing Hawaii income tax returns. To estimate deductions it was necessary to adjust and extrapolate the statistics reported by the Tax Office, for these data refer only to persons filing net income tax returns in 1948 and are tabulated according to <u>net taxable income brackets</u>, rather than adjusted gross income brackets. Four major steps were involved here. (i) The relationship between net taxable income brackets and adjusted gross income brackets was ascertained by finding, for each former bracket, the average adjusted gross income. The adjusted gross income brackets used in computing this table are 0-$500, $500-$1,000, then by $1,000 steps to $10,000, $10,000-$15,000, $15,000-$25,000, $25,000-$50,000, and over $50,000. In most cases the average gross income for a net taxable income bracket was found to fall reasonably close to the mid-point of an adjusted gross income bracket. (Thus the average adjusted gross income for taxpayers in the $2,000-$2,500 taxable income bracket of the Tax Office report was found to be $4,628.) Where the average <u>gross</u> income for a net taxable income bracket did not approximate such a mid-point, two succeeding net income brackets were considered jointly and their average adjusted gross income used to establish a relationship between these two types of income brackets. (ii) Average deductions--for federal income taxes, for other deductions, for total deductions--were computed for each <u>net</u> taxable income brackets. (iii) These average deductions were then related to corresponding adjusted <u>gross</u> income brackets on the basis of the fitting procedure outlined in (i). (iv) Total deductions, as given by the tax structures assumed in the table, were then computed for each gross income bracket by multiplying the estimated average deduction by the number of tax returns in the bracket.

Chart 1: ESTIMATED YIELDS FROM ALTERNATIVE INCOME TAX STRUCTURES (p. 19).

Estimates were made using the procedures outlined for Tables 4 and 5, applying the various rates, exemptions, and deductions shown in the legend of the figure.

Table 6: ESTIMATED REVENUE FROM TERRITORIAL TAX BASED ON INCOME REPORTED UNDER THE FEDERAL PERSONAL INCOME TAX (p. 27).

Personal exemptions were computed by the procedures outlined for Table 4 and federal taxes were estimated by the methods shown for Table 5. Computation of anticipated revenues was then made by applying against the estimated average taxable income for each adjusted gross income bracket the rates noted in the table, then multiplying the resulting average tax by the number of taxpayers in the bracket, summing up the total taxes paid in each bracket.

Table 7: ESTIMATED TERRITORIAL TAXES UNDER EXPANDED INCOME TAX COMPARED WITH PRESENT TAXES (p. 35).

Present taxes were estimated as for Table 2. Taxes paid at various income levels under the four hypothetical territorial taxes were approximated by

subtracting the exemptions indicated in the table, the estimated federal income tax, and other deductions--for which 5 per cent of the adjusted gross income was allowed. The federal tax, in turn was taken from the optional table for incomes up to $5,000, and was computed for higher incomes by allowing for the indicated exemptions, estimated territorial tax, and other deductions--the latter set at 8 per cent of adjusted gross income.

Table 8: INCOME TAX LIABILITIES UNDER PRESENT FEDERAL AND HYPOTHETICAL HAWAII INCOME TAXES (pp. 39-40).
Computations were made as for Table 7, allowing for inter-deductibility of federal and territorial levies in the case of Tax I. In both of these tables, as well as in Table 2, estimates of taxes paid by married couples were made by the use of separate returns, with income evenly split between husband and wife, where their combined tax was thus minimized.

APPENDIX IV

VERMONT INCOME TAX RETURN

FOR CALENDAR YEAR 1948 OR YEAR ENDING ____________ 194__

1. Gross Income, from Line 6 on Federal Form 1040 or 1040-A ____________ $________
2. Net income, Federal Form 1040, (Sch. D Capital Gains and Losses $______ omitted) ________ $________
3. Less: Federal Income Tax paid (Not over $500) ____________ $________
4. Other Deductions ____________
5. Credit for ______ exemptions at $500 each. (See instructions) ____________
6. Net Taxable Income ____________ $________
7. Enter amount of your tax on this line. (See instructions) ____________ $________
8. Occupation ____________
9. Social Security Humber ____________

PRINT NAME AND ADDRESS HERE

10. Give name and address of husband or wife if separate return is being filed.

____

____

I declare under the pains and penalties of perjury that this, to my best knowledge and belief, is a true, correct and complete return.

____

Signature of Taxpayer

____

Signature of Person Preparing Return

Detach and forward this copy to
Commissioner of Taxes

[Note: The actual form is 8 by 3 5/8 inches. Attached to it is a duplicate form and set of instructions, on the back of which is printed an optional tax table for persons receiving incomes under $5,000. The entire sheet, from which the above form is detachable by tearing along a perforated edge, is letter-size.]